



# SBLC WEEKLY

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## ***HERKY-JERKY***

We are in another of those two weeks stretches with one chamber in (the Senate) this week and one out (the House). They reverse status for the second week. I would say it upsets the rhythm and flow of Washington but that would presume there is a rhythm and flow.

The clock is ticking on a short term (six week) continuing resolution. In the meantime, the Committee of 12, charged with the deficit reduction work, has been very quiet. One could argue that is a good thing. They have until Thanksgiving to come up with a magic plan.

## ***CAPITAL FORMATION***

Sometimes there are issues that are good for small business, but do not make for interesting reading. (You will probably skip the first two pages of this Weekly too but I have to give it a shot.)

When I say, “access to capital,” I believe most of you will think “loan.” Access to equity investments is mostly for the “gazelles” among us, but we can dream. The House may consider some bills soon to open up that access. Some of them have bi-

partisan support. The notion of “crowdfunding” has particular currency as being “hip” (to date myself) on both sides of the aisle.

So here is our SBLC primer.

### ***Background on current law and regulations first.***

The *Securities Act of 1933* requires that investors receive financial and other significant information concerning securities being offered for public sale and it prohibits deceit, misrepresentations, and other fraud in the sale of securities. There are exemptions including what are known as Regulation A and Regulation D, described later.

The *Securities Exchange Act of 1934* created the Securities and Exchange Commission (SEC). The law gave the SEC power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the securities self-regulatory organizations. The law also gave the SEC authority to require periodic reporting of information by companies with publicly traded securities:

\*Companies with more than \$10 million in assets whose securities are held by more than 500

owners must file annual and other periodic reports.

\*Disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action. This information is referred to as proxy materials.

\*Disclosure of important information by anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer.

\*Regulation of insider trading which the SEC says “is illegal when a person trades a security while in possession of material nonpublic information in violation of a duty to withhold the information or refrain from trading.”

The *Investment Company Act* of 1940 regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.

The *Investment Advisers Act* of 1940 regulates investment advisers.

The *Sarbanes-Oxley Act* of 2002 mandated “enhanced” corporate responsibility, financial disclosures;

had provisions addressing corporate and accounting fraud, and created the Public Company Accounting Oversight Board (PCAOB), to oversee the activities of the auditing profession. Section 404 of the law has gained particularly notoriety. It requires public companies' annual reports to include the company's own assessment of internal control over financial reporting, and an auditor's attestation.

There are several ways for smaller business to sell securities without SEC regulation. They include private offerings, intrastate sales, Regulation A exemption and Regulation D exemption, employee benefit plan exemption, a California Limited offering exemption and an accredited investor exemption.

*Regulation A* exemptions are for public offerings not exceeding \$5 million in any 12-month period. The company must file an offering statement, consisting of a notification, offering circular, and exhibits, with the SEC for review. Regulation A offerings share many characteristics with registered offerings. For example, purchasers must be provided with an offering circular that is similar in content to a prospectus. Like registered offerings, the securities can be offered publicly and are not "restricted," meaning they are freely tradable in the secondary market after the offering. The principal advantages of Regulation A offerings, as opposed to full registration, are: The financial statements are simpler and don't need to be audited; there are no Exchange Act reporting obligations after the offering unless the company has more than \$10 million in total assets and more than 500 shareholders; companies may choose among three formats to

prepare the offering circular, one of which is a simplified question-and-answer document; and a company may "test the waters" to determine if there is adequate interest in the securities before going through the expense of filing with the SEC.

Since this topic is securities regulation, exemptions will be complicated and Regulation D falls in that category. *Regulation D* establishes three exemptions from Securities Act registration: They are referred to by their numbers: Rule, 504, 505 and 506. With all three Regulation D exemptions, public solicitation or advertising to market the securities must be used and purchasers receive "restricted" securities.

Rule 504 provides an exemption for the offer and sale of up to \$1,000,000 of securities in a 12-month period. For this exemption the company must register the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors; register and sell in a state that requires registration and disclosure delivery and also sell in a state without those requirements, so long the disclosure documents mandated by the state of registration is delivered to all purchasers; or, the securities are sold exclusively according to state law exemptions that permit general solicitation and advertising, so long as they are sold only to "accredited investors."

Rule 505 provides an exemption for offers and sales of securities totaling up to \$5 million in any 12-month period. Under this exemption, a business may sell to an unlimited number of "accredited investors" and up to 35 other

persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions. Purchasers must buy for investment only, and not for resale.

Rule 506 is a "safe harbor" for the private offering exemption. The conditions:

\*Cannot use general solicitation or advertising to market the securities;

\*While the securities can be sold to an unlimited number of accredited investors (the same group as in the Rule 505 and up to 35 other purchasers, unlike Rule 505, all non-accredited investors, either alone or with a purchaser representative, must be sophisticated - that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;

\*Must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings. If information is provided to accredited investors, this information must be made available to the non-accredited investors as well;

\*The company must be available to answer questions by prospective purchasers;

\*Financial statement requirements are the same as for Rule 505; and

\*Purchasers receive "restricted" securities and may not freely trade the securities in the secondary market after the offering.

Okay enough securities law for now. On to the proposals!

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### *Legislative Initiatives*

Without the background, most of the bills will not make sense if you read them and you know our motto, "We read 'em." The House Committee on Financial Services has approved several bills for consideration by the full House.

Check out these titles. How could one not be in favor of them? But you would never know what they do from the titles.

#### Column A

- \*1) The Private Company Flexibility and Growth Act
- \*2) The Access to Capital for Job Creators Act
- \*3) The Entrepreneur Access to Capital Act
- \*4) No title
- \*5) The Small Company Job Growth and Regulatory Relief Act

#### Column B

H.R.2167, introduced by Representative David Schweikert (R-AZ), changes the thresholds for total assets and for class of equity security holders of record which trigger the requirement for a securities issuer to register with the Securities and Exchange Commission (SEC). The bill increases the total assets threshold from \$1 million to \$10 million, and the class of equity security holders of record threshold from 500-750 to 1,000 persons.

H.R.2940 was introduced by Representative Kevin McCarthy (R-CA). As noted in the current law primer above, under Rule 506 of Regulation D, certain companies may be exempt from SEC registration if they meet specific conditions, including a prohibition on "general solicitation" and remain a private company. The general solicitation prohibition has been interpreted to mean that potential investors must have a pre-existing relationship with an issuer or intermediary before the potential investor can be notified that unregistered securities are available for sale. The legislation would remove the solicitation prohibition under Regulation D.

H.R.2930, introduced by Representative Patrick McHenry (R-NC) would permit "crowdfunding". Under current law, SEC registration is required if there are more than 500 shareholders. There are also prohibitions on general solicitation. The legislation would permit some small solicitations but conducted on a wider scale like through the Internet. The parameters would be for transactions involving the issuance of securities for which the aggregate annual amount raised through the issue of the securities is \$5,000,000 or less and the individual investments in the securities are limited to an aggregate annual amount equal to the lesser of \$10,000 or 10 percent of the investor's annual income.

H.R.1965, introduced by Representative James Himes (D-CT), increases the number of shareholders permitted to invest in a community bank from 500 to 2,000.

H.R.3213 was offered by Representative Stephen Fincher (R-TN). It expands the exemptions available to small companies from some reporting requirements of the Sarbanes-Oxley Act. Since 2007 the SEC has exempted small companies with a market capitalization of less than \$75 million and the Dodd Franks Act made that permanent. The bill moves it up to \$500 million and \$1 billion for some requirements.

Answers:

- H.R. 2167 - 1**
- H.R. 2940 - 2**
- H.R. 2930 - 3**
- H.R. 1965 - 4**
- H.R. 3213 - 5**